



***Final
Report***

County Of San Diego, California

Auditor and Controller

Grand Jury Audit of the City of San Diego Water Department Service Level Agreements

Office of **A**udits & **A**dvisory **S**ervices

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EXECUTIVE SUMMARY

At the request of the Grand Jury, the Office of Audits & Advisory Services (OAAS) has conducted a limited scope audit of the City of San Diego Water Department's FY 2004-05 Service Level Agreements (SLAs). The Grand Jury selected five (5) specific SLAs for review.

The Water Department utilizes SLAs to obtain services from a number of General Fund departments needed to carry out activities required for its mission. An SLA is an intergovernmental agreement that specifies services to be provided and the cost of these services. The objective of the audit was to determine whether the Water Department is using SLAs to subsidize services for other City departments using restricted funds and to establish the appropriateness of charges for services rendered to the Water Department under these agreements. The following summarizes our audit findings.

Questionable Use of Water Department Funds – Audit work revealed that expenses made under some SLAs appeared to be questionable due to the ambiguity of the services provided, the lack of documented oversight, and the absence of adequate documentation related to SLA expenditures. For example, OAAS questions whether the \$600,000 payment to the Parks and Recreation Department for the acquisition of rights to store water at Chollas Reservoir and the payment for the position that maintained the reservoir under one of the SLAs reviewed were appropriate. Also, OAAS believes that expenditures related to the operation of lake concessions under the SLA with the Parks and Recreation Department were excessive. In addition, we suspect that payments made under SLAs for services benefiting multiple City departments were too high. Specifically, management was unable to quantify services provided under two of the SLAs reviewed to substantiate payments made by the Water Department.

Lack of Effective Internal Controls for Service Level Agreements – Audit work determined that the Water Department does not have adequate internal control activities to administer the use of SLAs. Specifically, we found that some of the control activities essential for proper stewardship and accountability for government resources and for achieving effective and efficient program results are missing. For instance, OAAS found inadequate policies and procedures in place to administer the use of SLAs within the Water Department. Also, we identified a lack of inventory controls to account for assets purchased under one of the SLAs reviewed, which could prevent management from adequately protecting against the theft and misuse of assets and from determining whether monies are expended appropriately. In addition, OAAS' review of another SLA determined that no reconciliation for SLA payments was performed, preventing management from determining and validating actual costs incurred. Last, our audit found that SLAs were not formally monitored for performance hindering management from assessing the necessity and cost effectiveness of these agreements.

INTRODUCTION AND BACKGROUND

The City of San Diego's Water Department (Water Department or the Department) provides potable and recycled water to the United States' seventh largest city. The Department's primary objective is to provide the residents of San Diego with safe, reliable, and cost effective water. The Department also researches alternative water supplies such as recycled water, groundwater, desalination, etc. The Department provides additional services to the public such as water system repair and maintenance, lake recreation activities and water conservation education.

The Department is solely funded by Enterprise Funds. Enterprise Funds are self-supporting revenues generated by fees for specific services rendered. They are not subsidized by General Funds.

The Water Department utilizes Service Level Agreements (SLAs) to obtain services from a number of General Fund departments needed to carry out activities required for its mission. An SLA is an intergovernmental agreement that specifies services to be provided and the cost of these services. In 1996, the City Manager implemented SLAs with the intent of providing enhanced documentation and accountability for both service provider and customer departments.

During FY 2004-05, the Water Department's total budget was approximately \$358.6M. From this amount, approximately \$20.6M (6%) was budgeted for services provided through 31 SLAs.

AUDIT SCOPE AND LIMITATIONS

At the request of the Grand Jury, the Office of Audits & Advisory Services (OAAS) has conducted a limited scope audit examining the City of San Diego Water Department's FY 2004-05 SLAs. The Grand Jury selected five (5) SLAs for review. The objective of the audit was to determine whether the Water Department was using SLAs to subsidize services for other City Departments using restricted funds and to establish the appropriateness of charges for services rendered to the Water Department under these agreements.

The following SLAs were selected for audit review by the Grand Jury:

Service Level Agreements	FY	Amount
Water Department and the Office of Binational Affairs	FY 2004-05	\$34,445
Water Department and Park and Recreation Department-Chollas Reservoir	FY 2004-05	\$650,674
Water Department and Park and Recreation Department –Concessions	FY 2004-05	\$1,716,687
Water Department and the Equipment Department	FY 2004-05	\$126,899
Water Department and the Planning Department	FY 2004-05	\$373,674

OAAS' ability to completely execute this scope was limited by several factors, including: turnover of key City personnel, the lack of auditable records, and the unavailability of comparable benchmarking data from other governmental agencies that utilize SLAs.

This audit was conducted in accordance with auditing standards prescribed by the Institute of Internal Auditors, Inc., as required by California Government Code, Section 1236.

METHODOLOGY

OAAS implemented a multi-faceted methodology that included the following:

- Reviewed selected SLAs to obtain an understanding of terms outlined within each SLA;
- Conducted multiple interviews with City management, including Water Department management involved with administering and supporting SLAs;
- Inquired about available management reviews, studies, or audits performed on SLAs;
- Requested existing policies and procedures governing the use of SLAs;
- Evaluated internal control procedures over existing SLAs;
- Conducted limited benchmarking regarding the use of SLAs and related policies and procedures;
- Verified the validity of the established cost for services under each SLA by reviewing existing documentation that supported the rationale used to determine the cost;
- Validated actual costs charged for each selected SLA during FY 2004-05 by reviewing financial reports and timesheets and reconciling charges;
- Reviewed the overhead application process to obtain an understanding of the methodology used;
- Reviewed existing performance report for each selected SLA to ascertain the degree of management oversight of SLA performance; and
- Determined how services provided under selected SLAs assist management in meeting the Department's objectives.

FINDINGS

The following discusses the results of the OAAS audit on behalf of the Grand Jury examining the adequacy of internal controls over SLAs and the appropriateness of Water Department funds expended for these SLAs.

I. Questionable Use of Water Department Funds

During the audit, we discovered a number of cases in which payments made under the SLAs were questionable due to the ambiguity of the services provided. Further, cost allocation to the Water Department for SLA services benefiting multiple departments could not be validated and supported by appropriate documentation. Therefore, it appears that the Water Department might have inappropriately used water funds to subsidize General Fund departments' activities in several instances.

The City Charter and Municipal Code indicate that Enterprise Funds for the Water and Wastewater Department can only be used for improvements and maintenance of the waterworks of the City and for the acquisition of all lands, easements, rights and property necessary for such purposes.¹ Further, Enterprise Funds have clearly defined purposes and are protected under Proposition 218 amendments to the State Constitution.² Proposition 218 is designed to protect California taxpayers from "hidden taxes" in the form of fees assessed in excess of the cost of service being provided. In other words, if the City were transferring monies out of the water and sewer funds for other uses, it would inflate the "cost of service" in water and sewer with the excess charges constituting a hidden tax on San Diego residents.

¹ City Charter, Article 7, Subdivision 2.

² Pursuant to Proposition 218, fees collected by the City for the support of these funds (such as the water and sewer fees paid by San Diego homeowners each month) are to be used solely for expenses related to the specific services for which the fee was assessed.

Using these legal guidelines as review criteria, OAAS identified the following issues related to Water Department SLA expenditures:

Questionable Payments Related to Chollas Reservoir SLA – OAAS found that payments made to the Park and Recreation (P&R) Department related to the Chollas Reservoir SLA appeared to be questionable due to the lack of adequate support. The Water Department paid the P&R Department \$600,000 for the acquisition of rights to store water at the Chollas Reservoir.³ Management stated that the former City Manager made the decision to purchase the right to use Chollas Reservoir for the storage and distribution of water in order to address the City's need for future storage options of reclaimed water. Management provided a document that illustrated the rationale used to determine the one time fee of \$600,000 for the acquisition of water storage rights to the reservoir. However, we identified some issues related to the adequacy of documentation supporting the transaction. In particular, we found that management did not properly document and provide evidence as to the City's actual need for future storage options that required such a transaction.

In addition, OAAS found that there was no business case or similar analysis developed to validate the appropriateness of the \$600,000 cost for water storage rights. Management was only able to provide an informal document as support for making the decision to purchase these water rights (see Attachment A). Considering the significance of the transaction, a formal document on Department letterhead that included dates of when the cost calculation was prepared, the source of data used to establish such costs, management's approval of the cost methodology, and evidence of review by the Real Estate Assets Department, would have been appropriate.

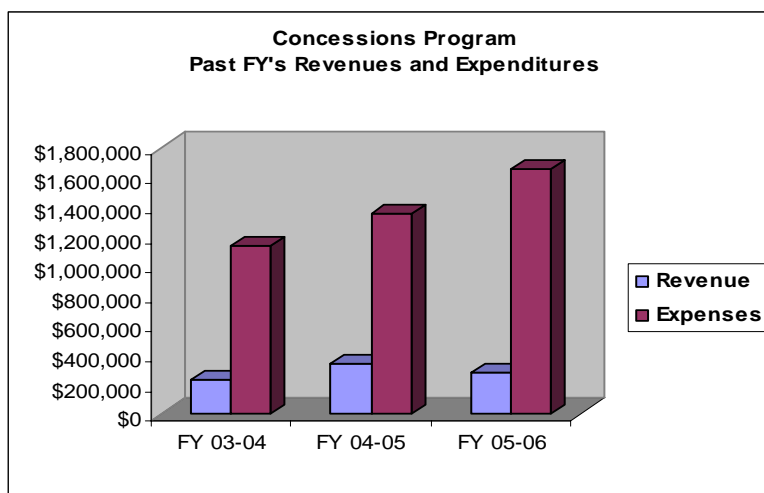
Furthermore, a second element of the SLA indicated that the Water Department was responsible to fund the salary and benefits, excluding overhead, of one full time position (Grounds Maintenance Worker) from the P&R Department to provide maintenance for the reservoir. Per the SLA, the total budgeted cost of this position was not to exceed \$50,674. OAAS found that the Water Department subsidized the position to maintain the reservoir in FY 2004-05 even though the SLA was not formally signed and finalized until FY 2005-06. In addition, actual payment to the P&R Department totaled \$84,888 and included overhead costs, thereby exceeding the SLA authorized amount by \$34,215. Further, audit work revealed that this position was not performing some of the activities outlined within the SLA.

Expenditures Related to the Lake Recreation Program SLA Appear to be Excessive – Expenses associated with the operation of lake concessions under the SLA with the P&R Department appear to be excessive in comparison to the revenues collected. The operation of lake concessions provides basic recreation services to the public. According to Council Policy 400-03, general water rates can be used to offset all costs associated with basic levels of public access, community usage and related grounds and facility maintenance.⁴ However, our review of financial status reports revealed that the net cost to the Water Department to provide such services has been unreasonably high when compared to the revenue generated. The following figures exhibit results of operation of the lake concessions since the inception of the SLA:

³ During FY 2004-05, the Water Department and the P&R Department created an SLA that included the purchase of rights to Chollas Reservoir to store water for \$600,000. Actual payment was made on October 27, 2005.

⁴ Council Policy 400-03 states that general water rates will be used to offset all costs associated with basic levels of public access, community usage and related grounds and facility maintenance (Tier I). Reasonable user fees will continue to offset the direct costs associated with Tier II Traditional Recreation Programs (fishing, boating, and waterfowl hunting) and Tier III Water Contact Program (water-skiing, jet-skiing, board-sailing) activities."

Figure 1 - Actual results of lake concession operations for FY 2003-04 and 2004-05. FY 2005-06 results are based on budget figures.



	FY 03-04 Actual	FY 04-05 Actual	FY 05-06 Budget
Revenues	\$ 231,700	\$ 340,899	\$ 282,530
Expenses	\$1,131,614	\$1,348,809	\$1,654,431
Net Loss	(\$899,914)	(\$1,007,910)	(\$1,371,901)
Percentage	80%	75%	83%

Net losses are solely financed with water funds; consequently the Water Department is subsidizing 75% to 83% of all costs associated with lake recreation programs. During our conversations with management, it was revealed that prior to the existence of the SLA with the P&R Department, lake concessions were operated by private contractors. According to Water Department management, although the level of customer service was deficient, the net cost to the Water Department was much lower than the cost under the SLA. Water Department management indicated that they are considering evaluating the program at the conclusion of FY 2005-06 to determine if they should discontinue some of the services provided in order to relieve the financial burden on the Department.

Subsidizing recreation programs with water funds that represent such a financial burden to the Department makes these expenditures questionable as to whether water funds are being used appropriately.

Questionable Percentage of Binational Affairs Coordinator's Salary Paid by Water Department – The percentage of the Binational Affairs Coordinator's salary allocated to the Water Department cannot be validated based on the number of water projects delivered. The SLA between the Water Department and the Office of Binational Affairs (OBA) indicates that salary of the Binational Affairs Coordinator is to be 25% funded by the Water Department.⁵ However, since the Binational Affairs Coordinator's timesheets do not account for hours by specific project, there are no records to indicate that 25% of the available hours were dedicated to water issues.

Further, based on our review, it appears that the Coordinator does not spend 25% of their time for water-related projects. Specifically, we discovered that the services provided under the SLA benefit multiple City departments which do not contribute to the funding of the position. OAAS reviewed the FY 2005-06 Strategic Plan document that outlines projects that the OBA will focus

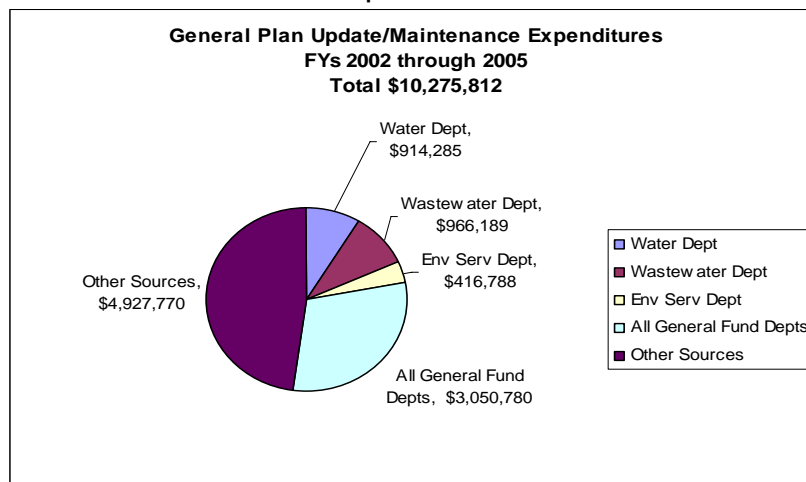
⁵ The Binational Affairs Coordinator is the leading position within the Office of Binational Affairs under the Governmental Relations Department.

on during the year. The Strategic Plan included various projects that pertained to other City departments such as the Planning Department, Police Department, Fire Department, Development Services Department, Real Estate Assets, and General Services Department, among others.⁶ OAAS noted that out of the thirty projects listed, only five (17%) appeared to be related to the Water Department. Although management indicated that the projects listed are not inclusive, they do not maintain accurate records of all the projects delivered by the OBA. Further, management indicated that they are not concerned with the number of projects performed by the OBA and who benefits from these services and that they do not actively and formally monitor activities performed under this SLA since the services required by the Water Department have been delivered.

Distribution of Cost Paid by the Department Related to the Planning SLA Appears to be Excessive – The proportion of cost paid by the Water Department for the establishment of the General Plan under the SLA with the Planning Department appears to be excessive. The purpose of this SLA is to develop and establish the General Plan Update that addresses growth and development strategies for the City of San Diego.⁷ The development of the General Plan benefits a number of City departments, as well as the private sector. There are two (2) full time positions solely funded by the Water Department at a cost not to exceed \$378,544 (salary, fringe benefits and overhead expenses).

OAAS was provided with the following data associated with total costs related to the General Plan Update and the corresponding cost to the Water Department since the inception of the SLA.

Figure 2 - Water Department's contribution to the Development of the General Plan from FYs 2002 through 2005⁸



As Figure 2 indicates, General Fund departments have contributed a total of \$3,050,780 (30%) to the \$10,275,812 total expense related to the General Plan Update while the Water Department alone funded \$914,285 (9%) since the inception of the project. During our interviews with management, it was revealed that there was no existing documentation that

⁶ Some of the projects listed in the Strategic Plan document included:

Expansion of the San Ysidro Port of Entry - Departments involved were Community and Economic Development, Planning, and Engineering Capital Projects.

Binational and Emergency Response Plan - Departments involved were Police and Fire-Rescue Services.

Construction of the SR 125 - Outside organizations involved were City of Chula Vista and the Otay Mesa Chamber of Commerce.

⁷ The General Plan Update lays out the City's twenty-year growth and development strategy. The Plan identifies where new growth should and should not occur. Further, the General Plan specifies the guidelines by which public facilities and services are to be planned and provided. The long range of planning efforts provides the necessary framework for City departments to plan for needed system improvements and upgrades over a twenty year period.

⁸ Other sources contributing to the General Plan Update are: Community Planning Otay Mesa \$192,141, Application Fees \$2,481,873, Trans. Planning \$1,589,645, Redevelopment Agency \$564,699, and Centre City Development Corporation \$99,412.

validated the distribution of costs. Management indicated that the current distribution ratio was determined by former City management. The lack of supporting documentation and the high percentage of costs funded by water funds leads us to question the appropriateness of the distribution of costs to the Water Department.

OAAS noted that City management has taken a proactive approach to this SLA regarding cost allocation. Due to the lack of adequate support, the former Deputy City Manager requested an independent fee analysis to determine the appropriate funding required from the Water Department for both past and future years. Planning Department management indicated that this study is currently in process and should be finalized before the end of the current fiscal year. This analysis may result in an adjustment of the total SLA funding amount in future years and may also necessitate a refund for payment made by the Department, if determined to be excessive. The resulting cost allocation should establish a fair share contribution to the General Plan Update efforts by all benefiting City departments.

Lack of Supporting Documentation Increases the Risk of Inappropriate Use of Funds -

The lack of adequate validation supporting expenditures made by the Department under the aforementioned SLAs and the absence of formal and effective monitoring exposes the Department to the potential over-funding of General Fund department activities and possible misappropriation of funds.

II. Lack of Effective Internal Controls for Service Level Agreements

OAAS found that the Water Department does not have adequate internal control activities to administer the use of SLAs. In particular, our audit found that control activities, which are essential for proper stewardship and accountability for government resources and for achieving effective and efficient program results, are missing. More specifically, our audit identified the following:

Inadequate Policies and Procedures to Administer SLAs – Audit work identified the lack of adequate policies, procedures, and related documented roles and responsibilities governing the use of SLAs. The only guidance provided is a memorandum from the former City Manager which instructed City departments to utilize SLAs and provided general guidelines for the negotiation of SLAs.

Lack of Controls Over Acquisitions of Assets – While reviewing the operation of lake concessions SLA with the P&R Department, we identified a lack of inventory controls and inadequate management review by the Water Department over the acquisition of assets at the lake concessions purchased under the provisions of the SLA.⁹ P&R staff purchases equipment and supplies to be used at the concessions and recovers their cost from the Water Department. The P&R Department does not prepare inventory schedules for Water Department review. In addition, Water Department management indicated that they had no need to review inventory records or to implement internal controls since they rely on P&R staff to make the appropriate decisions over purchase of assets and inventory control. The lack of efficient inventory controls prevents management from adequately protecting against theft and misuse of assets and from determining whether monies are expended appropriately.

Lack of Reconciliation for SLA Payments – Audit work determined that there was no supporting documentation available for payments made under the Equipment Division SLA. Specifically, OAAS discovered that there were no mechanisms in place to enable management to track payments made to the Equipment Division. In this case, the Equipment Division was

⁹ This SLA indicates that the P&R Department will operate lake concession facilities. P&R staff are responsible for operating snack bar and purchase necessary inventory, process boat and motor reservations, maintain accurate inventory records of permits sales, maintain buildings, and provide income and expense reports. The Water Department is responsible for salary costs associated with the SLA and inventory expenses were not to exceed \$1,716,687 during FY 2004-05.

supposed to incorporate the cost of the SLA into a vehicle usage rate fee. However, upon OAAS' review of detailed documentation related to actual charges during FY 2004-05, it was revealed that the Equipment Division did not include the SLA cost in the rate calculation for vehicle usage. Consequently, management was unable to identify and reconcile actual costs charged for SLA services provided by the Equipment Division during FY 2004-05. Water Department staff subsequently found that the Water Department was charged for these services but were unable to determine the exact amount.

SLAs Not Formally Monitored For Performance - Audit work discovered that during FY 2004-05, there were no performance metrics identified within the SLAs required to determine the effectiveness and efficiency of services provided. Additionally, formal performance status reports on SLA activities were not prepared by service provider departments or requested by the Water Department. As a result, there were no records available that demonstrated formal oversight and assessment of services provided under these SLAs. Moreover, the lack of performance monitoring indicates that there was no formal evaluation of SLA's performance from the standpoint of determining the necessity and cost effectiveness of these agreements. More specifically, OAAS found the following:

- ***Lack of Detailed Performance Reports Related to the Office of Binational Affairs SLA Activities*** – Audit work revealed that there were no formal performance reports that provided a status of activities performed under the SLA with the OBA. OAAS determined that while records exist that show projects to be completed by OBA during the year, there are no reports at the end of the year to indicate the progress on those projects. Therefore, management was unable to clearly identify the number of projects completed by the OBA for the Water Department or to formally evaluate the level of service provided.
- ***Performance Reports Related to Maintenance Activities for Chollas Reservoir Were Not Completed*** – This SLA requires that the P&R Department provide quarterly reports documenting maintenance activities and that the P&R staff perform and provide dam safety readings to the Water Department. Management was unable to provide reports from the P&R Department documenting the activities performed under the SLA. Further, it was revealed that some of the activities outlined within the SLA, such as dam safety and piezometer readings, were not performed at all by P&R personnel.
- ***Unavailability of Detailed Performance Reports for Activities Related to the Equipment Division SLA*** – There were no reports that provide details as to the total number of vehicles picked up and delivered for preventive maintenance under the SLA with the Equipment Division. Consequently, Water Department management is unable to quantify and assess actual services received from the Equipment Division.

Water Department management indicated that during FY 2004-05 such performance reports were not required for most SLA activities because they were not discussed during SLA negotiations. Additionally, management did not deem it necessary to formally review and assess actual performance since this information was obtained through other means (verbal communication, phone conversations, alternate reports, etc.). It should be noted that a number of FY 2005-06 SLAs now include performance metric requirements. Also, management indicated that performance measurement will be conducted going forward to ensure satisfactory delivery of SLA services.

REPORT DISTRIBUTION

This report is intended solely for the information of the San Diego County Grand Jury. Further distribution of this report is at the discretion of the Grand Jury.

COMMENDATION

We would like to thank the City of San Diego Water Department, the City of San Diego Auditor and Comptroller Department, the City of San Diego Office of Financial Management, and management and staff of service provider departments for the cooperation and courtesies extended to us while performing the audit.

AUDIT TEAM

Laura Flores, Associate Finance Auditor
Karen Dennison, Associate Performance Auditor

ATTACHMENT A

CHOLLAS LAKE/RESERVOIR

1. The Water Department will purchase the right to use Chollas Lake for the storage and distribution of water
- The right will last for the duration of the existence of the lake
 - The water department will make a one-time payment for the right
 - The water department may fill the lake with potable or recycled (Title 22) water
2. The storage purchase price will be based on comparable long-term lease costs for water storage
- Similar lease costs are estimated at \$150-\$200 per Acre Foot (AF) per year
 - Chollas can store about 303 AF
 - Annual lease value approximately = \$45,000-\$60,000 *PASS option*
 - One-time purchase price at about \$450,000-\$600,000 (10 X annual lease value) *over 10 yrs*
3. The Water Department also acquires the right to install necessary pumping station(s) and pipelines to feed water into the reservoir and to distribute the water from the reservoir at any time in the future
- The water department will pay fair market value for the necessary easements for pumping and distribution facilities at the time facilities are installed
 - If the water department is unable to obtain the necessary easements to install facilities, the general fund will repurchase the lake from the water fund for the original purchase price (in no case will this occur in less than ten years)
4. During the time the Water Department has storage rights, the Water Department will be responsible for supplying water to the lake
- The water department will maintain a level of xxxxxx in the lake *will operate the Res XX-XX \$100K annually*
 - The water department may fill the lake with potable or recycled water, or a combination of the two
 - The water level may be reduced during droughts
5. The Park and Recreation Department (Parks) will have the right to operate recreational programs at and in the lake
- Existing and future programs will be consistent with the nature of the water quality and source in the lake
 - The water department will reimburse Parks annually for one Grounds Maintenance Worker II (salary and benefits only) to provide for maintenance in and around the shoreline of the lake *#50K*

DRAFT
AGREEMENT
check with
H. D. Kelly
expans fishery
Program?
Comp 202?

MAY BE
THIS YR -
SAVE FOR
NEXT...